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The new instruments of risk management in agriculture in the European Union

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Abstract

The specific character of farming was perceived since the beginning of the creation of the European Community. Initiation and systematic evolution of Common Agricultural Policy aim at harmonious development farmstead. Any negative events, especially catastrophic, don't allow to execute plans and it can be a cause of abandonment of farms by farmers. This can upset the situation on food market. European Community, in its regulations, allows and even recommends the use of various support instruments. In response to Commission Regulation (EC) No 1857/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to State aid to small and medium-sized enterprises active in the production of agricultural products, subsidized crop and animal insurance were introduced in Poland. Much larger opportunities are offered by solution which are financed by assets derived from the mechanism of modulation and defined by Council Regulation (EC) No 73/2009 of 19 January 2009 establishing common rules for direct support schemes for farmers under the common agricultural policy and establishing certain support schemes for farmers. That can be wider range of subsidized crop, animal and plant insurance or mutual funds. Mutual fund is a mechanism that allows affiliated farmers pay compensation for economic losses incurred as a result of animal and plant diseases and environmental incidents. This regulation defines the financial rules of the fund and the possible use of this mechanism in the public and the EU. At the same time, there are many concerns about the practical implementation of this solution. Mutual fund can be a complementary tool for the protection of risks, which cannot be accepted by the insurance market. Experiences of Member States with regard to its use are small, but the examples of countries in which it operates (in this article indicates the Italian example) suggest that it may be a simple in its design but highly effective tool. And it will allow for more complete protection of agricultural production

The paper tries to identify the organizational and financial solutions to the mutual fund concept and proposed the establishment of specific solutions for this mechanism in Poland. This paper will present a discussion of the benefits from the introduction of this solution on the Polish and European market for agricultural insurance.

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1. Introduction

One of the key objectives of the Common Agricultural Policy is the stabilization of agricultural market. As a result, continuous works and considerations on risk management in agricultural holdings and agricultural income stabilization are in progress in the Union. The result of these works is the Council Regulation (EC) No. 73/2009 which establishes new tools for the implementation of insurance coverage supported (co-financed) by public and EU funds. Currently, works on the new shape of the regulation are underway, to adapt them to the objectives of the CAP assumptions after 2013. One of the instruments developed in this regulation is mutual fund. The concept of the fund is a mechanism that allows affiliated farmers to get a payment of compensations for economic losses incurred as a result of animal and plant diseases and the so called environmental incidents. This regulation defines financial principles of the fund functioning and the possibilities of using public and EU funds in this mechanism. At the same time, there are many concerns regarding practical implementation of this solution.

This article is an attempt to indicate organizational and financial solutions of a mutual fund concept. Since the experiences of Member States relating to the use of this instrument are extremely scarce, the article presents a concept of mutual fund currently existing in Italy and created in groups of agricultural producers. This article will also present a discussion on the benefits of the introduction of such a solution into the market of agricultural insurances.

2. Risks and risk management in agriculture

Agriculture is very strongly linked to natural conditions and the environment in which farming activity takes place. So besides universal, common to most types of business risks, such as operational risk, credit risk and market risk, agricultural holdings are exposed to risks due to the nature of agricultural activity itself, which are highly related to environmental conditions over which a man has no control Kłoczko-Gajewska&Sulewski (2009). Due to the length of the production cycle and thus slow circulation of the capital engaged in technology it is particularly susceptible to both productivity and economic risk.

In reference books the risk of agricultural production is classified in multiple ways. A. Miller and co-authors suggest that the risk was classified into: production risk (caused by weather fluctuations, crop and animal diseases and pests), price risk (caused by price volatility), disaster risk (floods, droughts, hurricanes, etc.) and technological risk (resulting from continuous development and adaptation of new techniques and methods in production) Miller et al. (2004). Another view on risk can be found in the study of the European Commission where the authors base the classification on the following risks: personal (such as loss of health, life by people working on the farm), institutional (political, trade regulations), financial (access to loans and the stability of crediting conditions, etc.), production (causes of the phenomena are due to climate conditions, pests, diseases, thefts, fires) and price (unfavourable changes in prices on agricultural products market and production factors) Agicultural (2006)

Understanding the origin and specificity of particular types of risk should lead to a risk management strategy. In the case of agricultural production, the objective of risk management should be to improve or maintain the income from an agricultural holding and its financial and organizational stability.

Within the traditionally distinguished stages of risk management (identification, assessment and response to risk) due to the subject of the work, the last one, in which there is a decision on the choice of risk management instruments, seems to be of key importance. It is worth indicating, however, that in this type of production agricultural risk management instruments may be related to both the decisions at the level of agricultural holdings as well as the State policy (Table 1).

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Table 1. Instruments mitigating the effects of risk in agriculture.

State interventionisme	Individual instruments
- **financial** – subsidizing of agricultural production or consumption through subsidies or tax allowances	- **consolidation of operations** – vertical (capital, contractual, institutional) or horizontal integration
- **protectionism** – reducing competitiveness of import through import quotas, customs duty, compensation prices and fees	- **diversification** of business directions - transactions on the **capital markets** (futures, weather derivatives)
- **control** – quality standards and rules regulating the turnover	- **reserves** (own, mutual fund) - **insurances** – commercial, possibly subsidized

Source: own study

The State through its agencies or available market instruments intervenes when it is appropriate to mitigate the effects of unforeseen events. It applies mechanisms of market regulation in order to prevent economic crises or takes actions with regard to financing the long-range effects of natural disasters. Gradual liberalization and opening up of agricultural markets and increasing budgetary constraints reduce, however, the ability of agricultural policy instruments to directly support holdings in a crisis situation as well as in the event of natural disasters.

3. Risk management in the common agricultural policy

Since the moment Poland accessed European Communities there are being implemented tasks related to the Common Agricultural Policy (CAP). Its concept is derived from Art. 3 of the Treaty of Rome which says that the activity of the Community includes the introduction of a common agricultural policy. The Single European Act extends the object of common activity by a common policy in the sphere of agriculture and fisheries. For many years the Common Agricultural Policy aimed at influencing the prices of agricultural products through a series of measures to stabilize the market and prices (subsidies for the production of certain species of plants and animals, guaranteed prices for certain agricultural products, protective mechanisms against importing cheaper products from abroad or subsidizing the export of surplus of more expensive European products to external markets). In January 1991 the Commissioner for Agriculture, Ray MacSharry, proposed changes which allowed for the inclusion of individual and regional needs of farmers into the discussion area. The MacSharry's reform has turned the support of manufacturing of particular products into the support of an agricultural producer and then also the support of the rural areas development. Separation of payments from the production was to have caused farmers grow for the market needs and not for the needs of obtaining a subsidy. "Agenda 2000", approved by the European Council in March 1999 as a preparation of CAP for the enlargement of the Union, has caused limitation of interventions in the product markets and the farmers becoming gradually accustomed to the prices which are realistic to be achieved on global markets. Łyskawa (2011) and Łyskawa (2008)

As a result of the mentioned reform and the subsequent changes, the CAP financing was based on the so-called two pillars. Pillar 1 covers the market and income support. It includes direct payments to farmers and it is the continuation of subsidies within the framework of Community Marketing Organizations (CMO) such as purchases for public stocks, surplus distribution schedules and export subsidies. Pillar 2 deals with rural development. The growing importance of rural development tools is aimed to extend services to the environment, the introduction of support for farms located in areas with difficult conditions, promotion of food quality, achieving higher standards of animals' welfare. As a result of further activities the so called modulation mechanism was introduced, which through reduction of the level of direct payments to land is expected to lead to a more effective use of resources directed to a given Member State. The money saved is to be spent on the development of rural areas Handschke& Łyskawa (2008)

In the European Union, within the framework of the CAP, works on risk management are in progress. In 2006 the European Parliament developed a resolution on risk and crisis management in the agricultural sector. The document pointed out the necessity of implementation of a conscious risk management by agricultural producers. Besides, the activities to support the management are, in line with the CAP, to be used primarily for the benefit of the public, ensuring the supply of healthy food and agricultural raw materials and environmental protection for people. At the same time, based on numerous observations it was indicated that the risk associated with agricultural activity will grow in terms of diversity, size and frequency. Another important document is the Commission Regulation (EC) No. 1857/2006. It has established the possibility of public aid for small and medium-sized agricultural enterprises. Additional aid for agricultural holdings resulting from this Regulation may be provided only in the event of adverse climatic event, which can be compared to a natural disaster. In accordance with the definitions specified in that Regulation an adverse climatic event which can be assimilated to a natural disaster means weather conditions such as frost, hail, ice, rain or drought which destroy more than 30% of the average of annual production of a given farmer in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and lowest entry. In addition an adverse climatic event which can be described as a natural disaster, must be formally recognized as a natural disaster by public authorities. In such an event a Member State may offer aid covering up to 90 percent of losses or for agricultural producers meeting the criteria of small and medium-sized enterprises, apply subsidies for insurance premiums even up to 80 percent of the costs of insurance premiums (for natural disasters) and a maximum of 50 percent of the costs of insurance premiums in the event of the coverage for smaller losses of climatic nature and events caused by animal or plant diseases or pest epidemics.

The analysis of the results of the use of funds for financing of the European Agricultural Fund for Rural Development (EAFRD) in 2007 showed that these funds are too small and the financial possibilities of Member States do not meet the budget needs for the implementation of the agreed tasks. A relevant document concerning the distribution of funds from modulation was drawn up at the beginning of 2009. In the introduction to the document it was emphasised that due to the increasing importance of the effective risk management Member States should be given the opportunity to co-finance insurance premiums paid by farmers in connection with crop, animal and plant insurance as well as to co-finance the compensations for certain economic losses in case of animal or plant diseases and environmental incidents. Within the analyzed scope, that is the sources of financing losses in agriculture, the key articles are Art. 70 and 71: “crops, animal and plant insurance” and “Mutual funds concerning animal and plant diseases and environmental incidents”. Janowicz-Lomott, Łyskawa (2009)

Currently, works on the CAP in a new financial perspective are being carried out. One of the EC’s proposals is to strengthen the existing tools within the scope of risk management. The proposals concerning risk management are:

- subsidizing of insurance contracts, including index insurances,
- financing the functioning of mutual funds,
- establishing and financing income stabilization tools, European Parliament (2012)

Rules of subsidizing insurance premiums will be based on the current scheme. A farmer or also a group of farmers are authorized to obtain an appropriate payment. The new idea is an insurance system based on indexes. Mutual funds are to operate under the existing rules (according to the Commission Regulation 73/2009), whereas it is proposed to extend the scope of the operation of a mutual fund by activities of harmful organisms and by adverse climatic events. In addition to the tools established by the Regulation 73/2009 (insurances and mutual fund) there is an idea to introduce an optional income stabilization tool, compatible with the WTO Green Box category Giersz (2011).

4. Mutual fund in the EU regulations

Regulation 73/2009 establishes special financial and organizational solutions for payment of financial compensations to farmers who have suffered economic losses caused by the outbreak of animal and plant diseases and the so called environmental incidents[†]. According to the latest proposals, also as a result of the activity of harmful organisms and adverse climatic events. These solutions consist in the possibility of granting a financial contribution to mutual funds.

Special attention should be paid to the concept of mutual fund. As defined in paragraph 2.a) of the Regulation a mutual fund is a scheme accredited by the Member State in accordance with its national law for affiliated farmers to insure themselves, whereby compensation payments are made to such farmers (affiliated in the fund) affected by

[†] Environmental incident shall mean a specific occurrence of pollution, contamination or degradation in the quality of the environment related to a specific event and of limited geographical scope. It shall not cover general environmental risks not connected with a specific event, such as climate change or acid rain.

economic losses caused by the above mentioned events. Such compensations shall be paid from:

- capital stock contributed to the funds by affiliated and non-affiliated farmers or by other operators in the agricultural chain,
- loans taken out by the funds on commercial terms,
- amounts paid to the fund when the farmer is entitled to receive compensation for economic losses from any third party (under the provisions of Community or national law) and he had already received compensation for the losses from a mutual fund.

An important record is the one that allows financing by the national budget up to 65 percent of the amount of expenditure incurred by the mutual fund as:

- the administrative costs of setting up the mutual fund, spread over a maximum of three years;
- the repayment of the capital and interest on commercial loans taken out for the purpose of paying compensation for losses or premiums for insurance contracts concluded with mutual fund at market price,
- the amounts paid by the mutual fund as financial compensation to farmers.

An important condition is the requirement that the initial capital cannot be financed with public money. An advantage of adapting this solution to national conditions is the possibility of co-financing by the European Community of the contributions made to mutual funds from public funds.

Another Regulation 639/2009 sets a number of requirements for Member States wishing to adapt the mutual fund concept in their solutions. They must specify:

- the conditions for financing the mutual fund,
- the outbreaks of animal or plant disease or environmental incidents which may give rise to compensation to be paid to farmers, including geographical scope where appropriate,
- the criteria for assessing whether a given event shall give rise to the payment of compensation to farmers,
- the methods for calculating of the additional costs which constitute economic losses,
- the calculation of the administrative costs,
- any limits to the costs that are eligible for a financial contribution,
- a procedure for the accreditation,
- procedural rules,
- the compliance and clearance audits that the mutual fund shall be subjected to following its accreditation.

Regulation 639/2009 (Art. 5) also requires Member States to report on the activities and financing of mutual fund. An important part of the report seems to be the record on transfer of information on any experiences of Member States in the scope of mutual fund concept implementation. This record may indicate that such measure is not identified enough in the European Community Bielza Diaz-Canej et al. (2009).

The mutual fund formula proposed by the Regulation is the closest to the well-known and quite popular in Poland concept of the neighbourhood self-help which has not taken the form of a formal organization. In rural areas (Polish regions – Radom, Kielce, Lublin or Tarnów) after the abolition of the compulsory insurance of animals against deaths, neighbourhood groups of mutual insurances began to operate and the subject of their activity has been the mitigation of the damage caused by deaths of cattle or horses. The premium, representing a defined market part of the animal, is paid by farmers at the moment they join the group (with time they may increase due to the increase of the market price of the animal) or in some communities annually, and then the contributions are properly deposited in a bank account. The difference between a mutual fund and a mutual insurance scheme (also a non-profit cooperation based on self-help) is the legal nature of the institution: For mutual insurance there is a legal title of compensation, and the premiums are calculated on an actuarial basis (as opposed to a fixed amount independent of risk) Schaffnit-Chatterjee (2010)

At the same time it should be noted that only in the case of this instrument there is a record that farmers are entitled to be paid compensation only if they undertook all necessary precautions in order to improve the resistance of their farms to the degradation of the environment, animal and plant diseases, harmful organisms and phenomena associated with the climate change. Mutual fund is therefore to assist other ways to reduce the risk of farming activity.

5. Mutual fund concept in producer groups in Italy on the example of Consorcio Difesa Produttori Agricoli CODIPRA in Trentino

Italian agricultural producers used mutual fund since 2002 but they didn't apply the possibilities given to them by the Regulation 73/2009. Actually mutual funds operate as a private funds. In Italy there are 66 such producer groups affiliated in one organization[‡]. The main task of these associations is to provide tools to manage productivity risk (mainly associated with climate conditions) and in this case two solutions are being used Cafiero (2004)(Figure 1):

- subsidized insurance,
- mutual fund.

The mutual fund concept, however, is more widely used in practice than it results from the Regulation 73/2009 Petronelli &Nizza (2012). They pay compensation when:

- damage to the crop related to adverse climatic events, plant and animal diseases when the value of the damage has reached the level below 30% of the average of annual production of a given farmer in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and lowest entry,
- damage to crops were associated to adverse climatic events which cannot be covered by insurance or which exceed the size acceptable by the insurance market.

The first of the considered areas of mutual fund activity supplements the area of subsidized insurances (introduced by Regulation 73/2009) Confederazione italiana agriconltori (2004). It was considered that the level of 30% of losses is very high, usually unattainable by agricultural producers. Losses below 30% may, however, undermine the stability of holdings and therefore should not be left without protection. In this respect, mutual fund is an alternative to commercial insurance coverage (not subsidized). At the same time mutual fund pays compensations only to those farmers who have insured the damage to crop in the same scope of coverage above the level of 30%. Insurance protection conditions are the same in both cases. The concept of compensation from mutual fund, however, has the possibility to reduce payments if the fund resources are insufficient to cover all reported losses. There will also be an opportunity to transfer a part of the risk to insurance.

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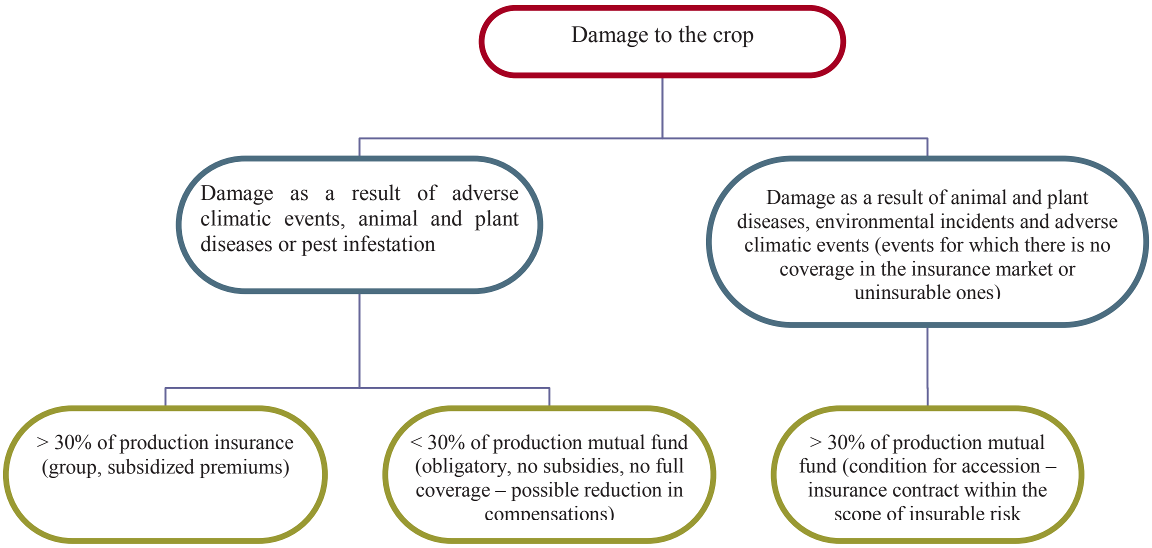

Fig. 1. Insurance Coverage Among Italian Producer Groups

Source: own study

[‡] http://www.asnacodi.it/index.php?option=com_content&view=article&id=29&Itemid=121

The main revenues of the CODIPRA fund in Trentino in the part related to the insurance below the level of 30% of losses constitute the premiums paid by farmers (in the organization's charter it has been determined that they should constitute 8% of the premium for the insurance, however, not less than 0.6% of the insured value) and also compensations paid by an insurance company (from the portion the fund has decided to insure). The costs of the Fund are primarily compensations, premiums for the risk transferred to insurance and administration costs (up to 3% of the premiums).
The coverage for uninsurable damages or for which there is no coverage in the market in CODIPRA relates to damage to fruit cultivation. The insurance shall cover the fixed cost incurred by the association in connection with the sale of fruits that have been delivered by farmers (eg wages of people working in the packaging, advertising costs, etc..). Compensation occurs when the damage will be realized in the fruit and the association does not receive the fruits from farmers and therefore not achieve planned sales, which would cover these costs. As part of a group insurance contract with an insurance company there was negotiated a solution that, in the case of damage at the level of losses above 30%, the maximum compensation may not exceed 130% of the premium paid by the insured. Higher damage will not be covered by insurance. Above this range, the compensations shall be paid by mutual fund Berti (2011).
Combining multiple sources of funding gives the farmers affiliated in a producer group a wide coverage protecting against a variety of fortuitous events and the fund performance suggests its high efficiency.

6. Adapting the Concept of Mutual Fund to Polish Solutions

Before 1990 a farm owner's duties in Poland in terms of conclusion and continuation of insurances were basically brought down to payment of designated premiums for insurance coverage. Even if the premiums were not paid still the insurance company was held responsible. Until 1990 the whole property constituting an agricultural holding was insured on an obligatory basis, i.e.:

- housing and utility buildings,
- movable property: machinery, tools and agricultural equipment, fertilizers, plant protection products, household belongings, animals
- crops: grain and mixes, buckwheat, corn, forage crops, potatoes, sugar beet as also grass from meadows and pastures;
- animals: horses and cattle, pigs (up to 1989),

The Act of July 1990 on insurance activity, which introduced a competitive insurance market in Poland, imposed on farmers an obligation to insure only the buildings associated with agriculture and to have liability insurance for running an agricultural holding.

In 2006 subsidized crop insurance was introduced. It was a response to the situation in Polish agriculture. On the one hand, after the socialist period, when crop insurance was compulsory, farmers virtually ceased to use this solution in a conscious risk management on a farm.[§] Basic problems reported by farmers concerned the amount of the premium. Polish accession to the European Union resulted in additional exclusion of the State's use of some instruments in the case of occurrence of catastrophic events (such as official prices, intervention buying, etc.). As a result was created an insurance product that will cover basic risks relating to crops that are on the territory of our country. At the same time there was created a premium subsidy system that was accepted by international structures. As a result of such changes it is estimated that in Poland about 28% of total crops is covered by insurance (about 140 thousand of contracts).

In the context of the development of the risk management concept in agricultural holdings in the European Union it seems to be important for the Polish agriculture to also implement other instruments permitted by the EU. The mutual fund concept implemented in several EU countries may be the answer to the problems of uninsurability or poor insurability of certain types of risk in the Polish agriculture. It could be supplementary to the already

[§] According to the data of PZU, still in 1988 almost 3 million contracts were concluded for the insurance of crops. In 2001 in Poland only 45 thousand contracts for the insurance of crops were recorded.

functioning in Poland system of subsidized crop insurance. (Figure 2)

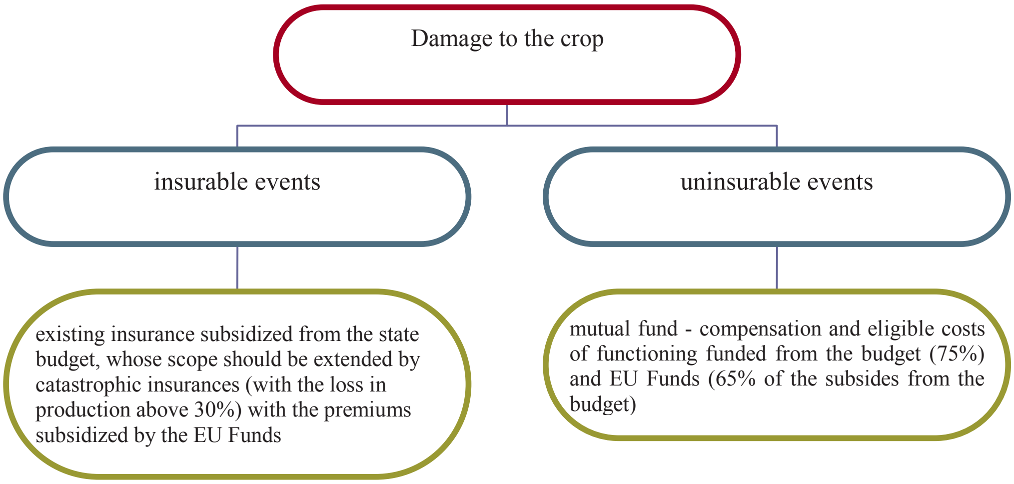

Fig. 2. The place of mutual fund in the concept of agricultural insurance in Poland

Source: own study

Implementation of this concept brings many benefits but also potential weaknesses of this approach (Table 2)

Table 2 Benefits and weaknes of mutual fund implementation

Advantages/Benefits	Disadvantages/Weaknesses
• Supplementation of the insurance system – more comprehensive coverage for farmers • Increased bargaining power of farmers • Possibility to use EU Funds • Reduction of information asymmetry • Possibility to use the data held by existing associations (also directly from the members) • New field of action for insurance companies (e.g., participation, group contracts) • Possibility to collect data and to insure risks for which there is insufficient statistical data	• Difficult start (lack of financing for initial capital) • Limited resources of the II pillar • Prevalence and limited compensation (possibility to limit the payments) • Requirement of full confidence between associations and their members, the need for full transparency of activity • Lack of experiences, solutions and political “favour”

Source: own study

Implementation of the mutual fund concept seems to be more important as it is to be the basis for the third of the risk management instruments in agricultural holdings – the income stabilization fund. The changes already implemented to the CAP and the plans for the next few years clearly show that farmers will have to take the responsibility for managing the risk that has formerly been mitigated by the market and price support policy. At the same time as a result of trade liberalization, EU farmers are increasingly exposed to competition and fluctuations in prices for agricultural products followed by the loss of income. In so far as the results of the realisation of catastrophic events may and should be taken over by the insurance market (with the possible support of the State or of the EU Funds), it is difficult to expect that insurance companies will take the responsibility to provide basic coverage for the income in the case of crisis situations. Janowicz-Lomott, Łyskawa, Zagórski (2013)

In addition, in the expectations defined in the documents of the Union we can find statements difficult to accept for insurance companies: “*the amount of payments for income stabilization must not solely relate to income and it must not relate to the type or volume of production of a given producer, domestic or international prices applied in such a production nor any other applicable production factors*” *Communication (*2005)

As a result, the key to effective management and control is the possession of an appropriate system for recording events that occur on the farm.

After Poland has accessed the European Union the accountancy had to be adapted to the European system of collecting accountancy data from farms FADN. The objectives and circumstances of creation of the Farm Accountancy Data Network (FADN) are explained by the contents of the Treaty of Rome establishing the European Economic Community and the preamble to the Regulation establishing the FADN system. As part of the preparation, and then adjustment of the Polish law to the European Union law, in 2000 the Parliament of the Republic of Poland passed an Act on Collection and Use of Accountancy Data from farms in order to determine annual income, make economic analysis and assess the situation in agriculture and agricultural markets. Act (2000) However, this tool due to its selective application[**] and technical burdens does not allow for its smooth application in the insurance scheme. As a result, there is a need to implement a comprehensive accountancy system in agricultural holdings or to create a reference income system at the level of agricultural holdings.

Such an elaborated instrumentation and long enough collection time of statistical data (also through participation of farmers in developing the income stabilization fund based on mutual fund) may allow for gaining the necessary experience to talk to the insurance market about the inclusion of insurance companies in the creation or co-creation of insurance products protecting farmers' income.

7. Conclusion

The Council Regulation (EC) No. 73/2009 did established a new tool of implementation of insurance coverage supported (financed) by public and EU funds, including the mutual fund. Such a solution seems to be a very important instrument for agricultural risk management supporting insurance solutions and strengthening the bargaining power of farmers. Merge into one crop insurance scheme and the concept of mutual fund can give farmers a more comprehensive protection - also in the event traditionally impossible to insure.

On the other hand mutual fund concept is based on mutuality in its simplest form. It is important not to miss that it allow to achieve benefits attributed to mutual insurances. In the case of agricultural production, it is undoubtedly the opportunity for a pioneering insurance of risks for which there is insufficient statistical data but also the possibility to base on the data in possession of the affiliated themselves (especially the producer groups, associations and agricultural cooperatives). It is clearly noticed that it ensures liquidation of information asymmetry (reduction of the risk of moral hazard) but of course it requires self-control of the members. One also cannot forget about the high social value of this kind of institution, which requires a true sense of relationship and trust in order to be developed, but it also promotes the sense of community in the course of its operation.

The state our reason in according to Polish conditions it is unquestionably that the threat for this concept is limited of the budget and the resources designated to the EAFRD (second pillar) of the Common Agricultural Policy. It is worth mentioning that the experience in this scope of Member States (Italy, the Netherlands) is little. The implementation of solutions form the mutual funds area seems, however, to be extremely important not only for the development of agricultural insurances or the protection in the scope of uninsurable events, but also because the income stabilization fund (the new tool in the scope of agricultural risk management) is to be based on the mutual fund concept as well. In the light of numerous opinions in the EU as regards the reduction or even liquidation of direct payments, it is the income stabilization fund that may become the tool to take over their role. Every Member ought to established its own road for an optimal conditions of functioning.

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